



Pricing - The Land of Opportunity

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All of us in the financial advisory world believe we are experts at cost reduction, productivity improvement, working capital reduction and idle asset sales. A smaller number of us believe we are good at growing top line sales. And very few of us focus much time and attention

in the area of clients' pricing. However, pricing can offer huge profit leverage opportunities for our clients. The following are "tricks of the trade" on pricing opportunities.

1. Pricing Analysis always starts with Gross Margin Analysis

One first must break up a business into manageable components upon which one can take action. The standard cuts of gross margin are by customer, by facility and by product line. Each of these three views is, in essence, a unit of decision-making.

In general, don't be overly worried about the likely inaccuracies of the client's cost data when one performs this analysis, because the question is rarely one of "absolute" gross margins, but one of "relative" gross margins by these standard cuts. Namely, one is looking for the lowest margin customers, plants and product lines to help focus management's efforts to improve profitability. Many times, gross margin analysis gets unnecessarily delayed and complicated because client cost data is somewhat dated and not particularly accurate. Do not get sidetracked by performing a complete cost database update or months will be lost in data correction rather than spent on corrective action, which is where the profit opportunity exists.

2. Develop Basic Industry Benchmarks for Gross Margins and Costs

One can rather easily research comparable gross margin and cost data for a client's industry segment. Do some research and figure how successful (not average) competitors perform financially. Using this basic benchmark analysis, one can quickly determine approximately how much of the client's gross margin underperformance is due to poor cost performance vs. how much appears to be due to pricing. If poor performance is due partially to weak pricing, one needs to go to work immediately. Note that it typically takes 3 to 9 months to fix pricing issues in a manner that doesn't potentially destroy the long-term relationship with that customer—this process is not a quick fix. Poor cost performance needs to be attacked as well, but that's a subject well covered elsewhere.

3. Classify the Customer Pricing Strategically and by Volume

Develop a basic gross margin matrix as a guide for pricing decisions with pre-established "target" margins and "minimally acceptable" margins. We

have found that the establishment of a gross margin matrix as a pricing policy tool eliminates a lot of ad hoc and ball-park pricing decision making that sales people often use. Too often, management makes important pricing decisions on the fly without any understanding of how one pricing decision affects overall profitability. This matrix helps put strategy into pricing decisions. An example follows for a client who operates in approximately a 20% gross-margin industry (a successful company benchmark).

Target Gross Margin	Strategic Importance of Customer		
	Low	Medium	High
Minimum Gross Margin	35%	30%	25%
	30%	25%	20%
Annual Sales	30%	25%	20%
	25%	20%	15%
Volume	25%	20%	15%
	20%	15%	12%

4. Review "Net" Pricing, Not Gross Pricing

It is critical to consider all costs directly related to sales volume and selling prices as a true deduction to gross sales. The net price is the true price paid by the customer, while the spread between net price and the gross price is a key variable to manage on pricing. Direct costs that need to be deducted from price include product returns, other credit adjustments, promotional discounts, co-op advertising, upfront monies, rebates, outbound freight and direct sales commissions. Many management teams don't understand the importance of "net" prices and the impact on gross margins and profits of these direct costs that savvy buyers negotiate. Often times, no one even realizes the full economics of all costs that are deductions from gross sales. It is absolutely critical to forget about gross prices and instead think about net prices.

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5. Develop a Pricing Action Task List

First, words of caution: one can't successfully overcome a cost non-competitiveness problem of a business by increasing prices, as customers will opt to resource one rather than overpay. This is true today more than ever, as China and many Far East manufacturers have 30% to 50% cost advantages over U.S. manufacturers in many commodity products. That being said, most of us regularly under-price goods and services, because we aren't trained to deal with the standard price objections that customers usually raise, whether it's real or simply a negotiating tactic. Therefore, it's important to develop an action list of customer pricing opportunities to attack based upon a relative gross margin analysis by customer. Develop a top-10 type list to focus near-term efforts on those customers where it's possible to have an impact on 80% of the overall pricing problem.

6. Understand Variable Contribution vs. Gross Margin

Once the top-10 low-margin list is completed, spend a little time analyzing the variable contribution margin of each customer. For this exercise, it is very important to use current cost data (not standards or quotes) for direct labor and direct materials/ components, plus an estimate of other variable costs. The key question here is whether one will gain profit or lose profit "incrementally" if all of this customer volume goes away tomorrow. Don't even think about burden absorption and the black science of cost accounting. This will only confuse this issue and, frankly, lead to a bad decision. It's enough simply to know how much incremental "cash" profit or loss each of these top-10

low-gross-margin customers generates at current pricing.

7. Be Willing to Fire the Customer

Not every one of the client's customers can be made into profitable business. Price concessions and other costs directly related to prices for some customers make it impossible to make a profit. At times, operations, cash flow and even the spirit of an organization can be dramatically improved from not servicing these customers, and gross margin analysis combined with variable margin analysis will show this. When price increases or cost reductions cannot be made to balance the relationship, it is better to end the relationship altogether. In some industries, customers will automatically resource work if the vendor demands a price increase, even if it means paying the same increase elsewhere. Politically, they just can't let suppliers win price increases, so believe it or not, they may accept the costs and risks of a supplier resourcing even if pricing options are not different. The Big 3 auto companies certainly adhere to that type of game plan.

8. Raising Prices

Once the customers who represent the best pricing opportunity are identified using the basic gross-margin matrix for the top 10 accounts, send the salesperson with a senior operating manager to visit the customers and lay out the objective and analytical case why there is no choice but to raise the prices to that customer. An operating manager's involvement is strategically important as it demonstrates to the customer the seriousness of the intent to increase the price.

We always suggest handling a

"beta" high-volume customer first before launching a more widespread customer approach. This allows the sales and operating team to fine-tune the pitch and market-test increased prices while avoiding the risk of attacking many customers at the same time. Of course, if one's client is in a financial crisis, one must move much faster than one customer at a time!

Final Thoughts

Prices most likely can be increased on service parts and small-volume customers by 10% to 15% with little or no lost volume. The key issue here is doing this in an even-handed and upfront manner with some reasonable notice period (30 to 60 days). This is a very low-risk tactic and can give one a profit boost rather quickly.

Our experience is that management is overly hesitant to attempt to get price increases for fear of losing customers. However, if one follows the steps outlined, in the final analysis, customers will usually act in their economic best interest. That means the client will not lose a significant amount of "profitable" business, and gross margins and profits will be significantly improved. This is true unless the client is significantly higher priced than its competitors, or has quality or service problems that already endanger a hold on their customers regardless of price. But that's a topic for another time.

Sidebar

The Power of Pricing

Situation:

- \$50 million (M) annual sales EBITDA breakeven
 - o \$45M equipment sales
 - o \$5M spare parts sales at \$2.5M positive variable contribution margin
- \$15M of equipment sales designated

as relatively low margins across top 10 low-margin accounts as follows:

- a. \$5M (2 accounts) at \$500,000 negative variable contribution margin
- b. \$5M (4 accounts) at breakeven variable contribution margin
- c. \$5M (4 accounts) at \$500,000 positive variable contribution margin

Action:

- Management agrees to advise above 10 customers that pricing will be increased such that variable contribution margins are a minimum of 20%. Management agrees to turn back business to customers if price increases are not received.
 - o Price increase by category is A-30%, B-20%, C-10%

Results:

Client lost 70% of A, 40% of B and 30% of C business, but retained the balance of business.

- Price Increases/Improved Margin
 - a. $\$5M \times 30\% \text{ price increase} \times 30\% \text{ retention} = \$450k$
 - b. $\$5M \times 20\% \text{ price increase} \times 60\% \text{ retention} = \$600k$
 - c. $\$5M \times 10\% \text{ price increase} \times 70\% \text{ retention} = \$350k$

Sub-Total
\$2,075k

- Lost Business/Lost Variable Margin
 - a. $\$5M \times 70\% \text{ lost volume} \times (10\%) \text{ variable margin} = \$(350)k$
 - b. $\$5M \times 40\% \text{ lost volume} \times N/A \text{ variable margin} = \emptyset$
 - c. $\$5M \times 30\% \text{ lost volume} \times 10\% \text{ variable margin} = \$150k$
Service Parts: $\$5M \times 10\% \text{ lost volume} \times 50\% \text{ variable margin} = \$250k$

Sub Total \$50k

- Net Margin Improvement/EBITDA Pickup
\$ 2,025k

This simple exercise adds 4% points (\$2M on \$50M) to the overall profitability of the business for a \$2 million pickup. Note that category A low-gross-margin customers are

priced so low that the profitability of the business actually improves simply by getting rid of this business. Believe it or not, we encounter negative variable contribution margin customers at clients regularly. ■

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